RECEIVED
APR 07 1994

ALJ/TRP/sid

Mailed

APR 7 1994

Decision 94-04-044 April 6, 1994

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Sacramento-Valley Limited Partnership (U-3004-C) for Authority to Increase the Rates and Charges Applicable to its Cellular Radio Telecommunications Service.	Application 93-07-017 (Filed July 9, 1993)

Michael W. Mowery, Attorney at Law, for Sacramento-Valley Limited, Partnership, applicant.
Peter A. Casciato, Attorney at Law, for Cellular Resellers Association, Inc., protestant.
Morrison & Foerster, by Dhruv Khanna, Attorney at Law, for McCaw Cellular Communications, Inc., interested party.

INDEX

INTERIM OPINION

I. Introduction

On July 9, 1993, Sacramento-Valley Limited Partnership (SVLP or Applicant) filed its application for authority to increase its general rates for cellular radio telecommunications service pursuant to the Public Utilities (PU) Code §§ 454 and 701. SVLP is a facilities-based cellular carrier providing wholesale, retail and roamer service. Pac Tel Cellular is the general partner of SVLP with 49.88% ownership interest. The limited partners are Roseville Telephone Company, Centennial Cellular, Evans Cellular, and Contel Cellular. The rates proposed in the July 9 filing are presented in Appendix A.

On August 13, 1993, Cellular Resellers' Association, Inc. (CRA) filed a protest, requesting that the application be set for hearings. CRA is a nonprofit mutual benefit corporation composed of certificated cellular telephone service resellers. No other party formally protested the application although letters were received by the Commission from SVLP customers complaining about the proposed rate increase.

A prehearing conference (PHC) was held September 27, 1993 to discuss the merits of the protest and to set a tentative schedule in the event hearings were ordered. An administrative law judge (ALJ) ruling dated October 28, 1993, granted CRA's request for hearings, directed the Applicant to supplement its application with additional support for its requested rate relief. In response to the ALJ ruling, the Applicant filed a supplement to its application on November 19, 1993. The ALJ requested additional supplemental information which the Applicant provided in responses on a confidential basis under General Order 66-C.

On December 14, 1993, the Applicant and CRA jointly filed a motion for adoption of a Settlement Agreement (provided as Appendix B). Contingent upon approval of the Settlement, CRA withdrew its protest to the application and request for hearings. Accordingly, the scheduled hearings were cancelled. The assigned ALJ then undertook a review of the application as amended by the Settlement Agreement.

By this decision, we reject the Settlement Agreement as presently written. The Settlement Agreement does not meet our criteria for adoption as an all-party settlement in that the interests of retail customers are not adequately represented thereunder. Also, the Settlement is binding only on the condition that an ex parte order is issued approving the application as amended and the Settlement Agreement without change. On this basis, we must test the reasonableness of the proposed retail and roamer rate increases on the merits of the substantive materials included in the application. We conclude that the application fails to provide sufficient evidence to justify ex parte approval of the requested retail and roamer increases. Accordingly, since we decline to approve the requested retail and roamer rate increases, we must reject the Settlement Agreement since one of its key terms cannot be satisfied. Likewise, absent the Settlement Agreement, we do not find sufficient evidence to approve the wholesale rate increases under the original application.

According to its terms, if the Settlement Agreement is not approved without change, the parties revert to their original positions. As such, CRA's protest becomes reactivated with its request for denial of the wholesale rate increase and for evidentiary hearings to consider a wholesale rate decrease. The applicant renews its original request. The options available to the parties at this point are to:

1. Amend the Settlement Agreement such that it is not contingent upon adoption of any specific increase in regular or roamer

service for retail customers. In this case, a final decision could be issued on the merits of the settlement insofar as it is limited to reseller issues and on the remainder of the application based on the merits of the direct showing of applicant; or

2. Discontinue further attempts at settlement and propose reinstituted schedules for discovery and evidentiary hearings on disputed issues as originally ordered pursuant to the ALJ ruling of October 28, 1993 adjusted for the passage of time since the settlement agreement.

II. Summary of Application and Settlement Agreement

Applicant requests to increase rates for retail, wholesale, and roaming cellular services throughout its service territory. Applicant's service territory encompasses the following:

a. as Area A the Counties of Sacramento, San Joaquin, Sierra, Stanislaus, Sutter, Yolo, Yuba City, Colusa, Nevada, and Placer.

b. as Area B, the Counties of Butte, Glenn, Shasta, and Tehama.

We established rates initially for the Applicant in 1985 based on consideration of the expected value of service standard established in Decision (D.) 85-05-041.

Applicant's proposed rate increases by individual billing element are set forth in Exhibit G to the application. Applicant projects that the rate increases originally proposed would increase 1994 operating revenues by the amounts shown below:

Service Sector Revenues ($000s)

	Present Rates	Proposed Rates	$ Increase	% Increase
Wholesale	$ 755	$ 805	$ 50	6.6%
Retail	3,228	71,157	7,929	12.5%
Roamer (net)	4,295	6,233	1,938	45.1%
Total Revenues	$62,278	$78,195	$9,917	14.5%

As amended by the Settlement Agreement, the revenue increase would be lower by an estimated $28,000, or 0.2% due to wholesale rate and roamer margin adjustments. The effects of the Settlement Agreement on reseller margins is discussed below. The Settlement Agreement makes no change in the proposed retail rate increases.

A. **Wholesale Rate Increase**

Applicant proposed wholesale rate increases are set forth in Exhibit G of the application. The magnitude of rate increase experienced by individual customers would vary depending upon area, volume of usage, and time of use. For resellers with more than 100 numbers and 20,000 peak minutes, an Area A Basic Wholesale Plan end user with 150 minutes of usage and no optional features would generate a monthly bill increase of 17% from $42.32 to $49.51. This increase includes the impact of expanding peak period billing to include Saturday service from 7:00 a.m. to 8:00 p.m. New airtime discount tiers and elimination of monthly feature charges could serve to mitigate the other billing increases.

In its Protest to the Application, CRA claimed that SVLP's wholesale rate increase could not be justified. CRA cited reported earnings from SVLP's 1991 and 1992 Annual Reports indicating that retail operations showed a net deficit while wholesale operations showed a net gain. CRA stated that the applicant had been engaging in anticompetitive cross-subsidization, using wholesale profits, derived from charges to resellers, to buy channels of distribution and thereby foreclose competition by resellers.

Subsequently, CRA entered into a settlement of all disputed issues with Applicant. On December 14, 1993, the Applicant and CRA jointly submitted the Settlement Agreement for adoption. On the basis of the amendments to the application adopted in the Settlement, CRA withdrew its protest without prejudice, contingent upon Commission approval of the Settlement Agreement in its entirety on an ex parte basis. Otherwise, parties state the settlement becomes null and void, and parties return to their pre-settlement positions, requesting reinstatement of the discovery, testimony, and hearing schedule, modified by the time elapsed since reaching the Settlement.

The settlement amends Applicant's original request by improving the profit margins for resellers with respect to wholesale airtime rates for peak and off-peak usage. The settlement also provides resellers a margin for roaming, as described below. The original application request involved five tiers for peak usage going from 20,000 minutes up to 750,000 minutes, with margins progressing from about 18% up to 30%. The settlement results in four tiers going from 13,000 minutes up to 150,000 minutes, with margins progressing from about 20% up to 30%. Under the settlement, resellers could benefit from increased margins at lower usage levels. Similarly, the Settlement reduces off-peak usage levels to four tiers, with the top tier being reduced from 112,000 minutes to 37,500 minutes.

The Settlement does not resolve the underlying substantive issues initially raised in CRA's Protest relating to the proper cost allocation methodology between wholesale and retail operations as a basis to check against anticompetitive cross-subsidization. The Settlement does provide a pragmatic compromise which both parties accept for purposes of this application.

and the proposal to charge all customers for special features that only some used.

The Applicant justifies its proposal to expand peak billing hours to include Saturday service stating that peak periods have traditionally been linked to business and commute hours when system usage is higher. As the work force has begun working longer hours, including Saturdays, and commute periods have lengthened, the Applicant feels that the inclusion of Saturday as a peak period is appropriate. Since its direct competitor has expanded its peak periods, the Applicant believes its proposed peak periods will keep it competitive while improving its low rate of return.

C. <u>Roamer Rates</u>

Applicant's proposed changes in roamer rates are set forth in Exhibit G of the application. The percentage increase in roamer rates range as high as 560% for off-peak usage for out-of-state roamers. Applicant projects a 45.1% increase in 1994 roamer revenues resulting from its proposed roamer rate hike. In its initial application, the Applicant proposed to charge the same rate for roaming during peak and off-peak periods applicable uniformly within Areas A and B. California-based roamers would pay a lower rate (79 cents/minute) than out-of-state roamers (99 cents/minute). Applicant's customers roaming elsewhere within California would not pay more than 60 cents/minute, with no daily access charges.

In its Protest, CRA did not contest the roamer rates proposed for retail customers, but objected that the Applicant provided no roamer margin for resellers. CRA interprets D.90-06-025 as contemplating a sharing of roaming revenues among carriers. CRA believed that resellers should receive a share of the roaming revenue at the same margin as the basic wholesale margin.

In its Reply to the Protest, the Applicant acknowledged that its proposed rates provided no margin for roaming. Yet, since D.90-06-025 permitted resellers to increase their roaming rates to cover whatever costs they incurred, the Applicant believed that no margin for roaming is necessary.

As agreed to in the Settlement, resellers' end-users which roam within any of the SVLP or Modoc RSA Limited Partnership California serving areas would have their usage rated at the appropriate wholesale rate for that area. Resellers would receive a 25% discount when end-users of such resellers roam on systems operated by an affiliate of SVLP's general partner, PacTel, in Los Angeles or San Diego, California.

III. Reasonableness of the Proposed Settlement

The Settlement Agreement jointly sponsored by Applicant and CRA resolves all disputed issues between the parties. Particularly in recent years, we have generally encouraged settlements among parties to resolve disputes as a way to avoid costly and protracted litigation. In this proceeding, the ALJ encouraged the parties to pursue settlement in his October 28, 1993 ruling. The mere fact that parties offer a settlement, however, does not relieve the Commission of the ultimate responsibility of independently evaluating the reasonableness of the settlement in a manner consistent with the public interest. As we have previously stated:

> "Parties to the settlement may chafe at what they perceive as intrusion on bargained-for deals and may believe that this Commission should simply take their word that the settlements serve the interest of the public in addition to the interests of the settling parties. However, settlement brought to this Commission for review are not simply the resolution of private disputes, such as those that may be taken to a civil court. The public interest and interests of the ratepayers must also be taken into account, and the Commission's duty is to protect those interests." (37 CPUC2d at 360.)

Thus, in crafting settlements, parties must consider the risks that the settlement will not be adopted and that ultimately, the proceeding may be delayed rather than expedited.

Rule 51.1 of the Commission's Rules of Practice and Procedure addresses the general rules governing stipulations and settlement, and distinguishes between those settlements which are supported by all parties to the proceeding (an "all-party settlement") as opposed to those which are contested. Generally, in order to adopt a settlement, whether contested or not, we must find that it is
(1) reasonable in light of the whole record, (2) consistent with the law, and (3) in the public interest. (D.92-12-019, p. 13.) In D.92-12-019, we articulated our policy as to the role which all-party settlements can play in assisting the Commission in discharging its regulatory responsibilities.

We stated that as a precondition to approval of an all-party settlement, the Commission must be satisfied that the proposed all party settlement:

a. commands the unanimous sponsorship of all active parties to the instant proceeding;

b. that the sponsoring parties are fairly reflective of the affected interests

c. that no term of the settlement contravenes statutory provisions or prior Commission decisions; and

d. that the settlement conveys to the Commission sufficient information to permit us to discharge our future regulatory obligations with respect to the parties and their interests.

Since there were only two active parties to this proceeding, and they both support the Settlement Agreement, the first precondition regarding unanimous support is satisfied. Likewise, no term of the settlement explicitly contravenes any statutory provisions or prior Commission decisions. Yet, to the extent that the proposed rates under the settlement would be unreasonably high, the settlement could conflict with our pervasive goal of protecting consumer interests. Regarding the fourth precondition, there is uncertainty as to what our future regulatory obligations will be with respect to the applicant or CRA pending the outcome of the Wireless OII proceeding. As such, it is difficult to assess whether the information conveyed in the settlement would be adequate to permit us to discharge those obligations.

Of more concern, however, the Settlement Agreement into which the parties have entered does not meet our second stated precondition for all-party settlements. The Settlement parties do not reflect representation of all affected interests, specifically those of retail customers. Neither CRA nor the applicant represent the affected interests of retail customers of SVLP. CRA's interests are those of cellular resellers involving assurance that they can compete fairly in the cellular marketplace. CRA's membership is composed of non-facilities-based cellular resellers who compete within California. In particular, neither the Commission's Division of Ratepayer Advocates or any other consumer representative formally participated in the proceeding. The lack of formal representation of consumer interests is all the more of concern because of the objections to the rate increase expressed by individual customers in letters.

The fact that CRA has negotiated improvements in resellers' margins does not satisfy us as to whether those margins are achieved at the expense of retail rates being too high. As stated in CRA's protest, "Whatever the merits of the PacTel retail rate increase, the wholesale rate increase cannot be justified." (Page 4.) Thus, the reasonableness of retail rates was not the focus of CRA's inquiry.

Accordingly, the Settlement Agreement cannot substitute for a substantive review of the merits of applicant's proposal for retail and roamer rates. The Settlement Agreement does not relieve the applicant of proving that its request is reasonable. As we stated in a 1987 rate decision concerning Pacific Bell:

> "Whenever the utility comes before this Commission seeking affirmative rate relief, it fully exposes its operations to our scrutiny and review. It must justify the reasonableness of its request and operations by making at least a prima facie case of reasonableness, even in the absence of opposition. Where it faces opposition, its reasonableness showing is naturally a more difficult undertaking." (27 CPUC2d 1,21; D.87-12-067).

As discussed below, we conclude that applicant has not met its burden of proof to justify an increase in retail or roamer rates, as proposed at this time. Since we decline to approve these proposed increases, the Settlement Agreement by its own terms becomes nonbinding. Moreover, a Settlement Agreement which requires approval of unreasonably high retail and roamer rates is not in the public interest. Accordingly, we cannot approve it.

IV. Regulatory Framework for Evaluating Cellular Rate Increases

The Applicant's rate increase must be evaluated in the context of the Commission's regulatory framework for the cellular industry and in conformance with adopted standards for just and reasonable rates. SVLP's application comes at a critical transition period in our continuing steps to determine the competitive state of the cellular industry and the proper regulatory oversight protocol.

As a context for evaluation of SVLP's application, we must consider the nature of the cellular industry in relation to our traditional mandate to regulate prices of monopolistic enterprises. The Federal Communications Commission (FCC) in the early 1980s established a duopoly structure for the cellular industry. Within each of 18 metropolitan statistical areas (MSAs) and 12 rural statistical areas (RSAs) in California for the provision of cellular service, the FCC issued two permits awarded through lottery selection. The FCC structured its duopoly framework so that one wireline and one nonwireline carrier would be permitted to serve each statistical area. (See, e.g., Re Regulation of Cellular Radiotelephone Utilities, D.92-10-026, 138 PUR4th 45,46-47.

When the first applications to provide cellular service in California came before us in 1983, we faced a broad strategic choice. On the one hand, we could have treated cellular carriers as monopolists subject to strict cost of service rates. However, we were uncertain as to the actual competitiveness of the duopoly, the likely progression of technology, and how commercially essential cellular would become.

With the experience of several years of cellular service in California, we opened Investigation (I.) 88-11-040 on November 23, 1988 to assess whether the cellular regulatory framework established in 1984 was meeting Commission objectives and if changes to the framework were warranted. Pursuant to I.88-11-040, we issued D.90-06-025 (36 CPUC 2d 464) addressing the issue of the proper regulatory framework under the FCC's duopoly facilities-based market structure. Our intent in D.90-06-025 was to establish a framework conducive to cellular competition and innovative cellular services. We concluded that cost of service regulation was problematic in a competitive industry like cellular that is undergoing rapid technological change. Nonetheless, we did not relieve cellular providers seeking to increase rates from providing supporting evidence. Ordering Paragraph 9 of D.90-06-025 required that:

> A cellular carrier seeking an increase in rates shall substantiate its request in an advice letter filing and shall provide:
>
> a. Market studies based specifically on data within its respective MSA.

b. Actual return on investment data for its prior three calendar years.

c. Projected return on investment based on its proposed rates.

d. Explanation of any major change (50 basis points) in the projected return on investment over three-year recorded average.

e. Cost-support data as requested by Commission staff.

Subsequently in D.92-04-081 (Re Fresno Cellular), we noted that the Commission and its staff were having difficulties in evaluating compliance with Ordering Paragraphs 9 and 15 of D.90-06-025, stating that what was required "is ambiguous and appears to be inconsistent with the overall regulatory framework which was established for cellular entities." We accordingly reopened our cellular investigation to reexamine Ordering Paragraph 9 of D.90-06-025. In October 1992, we issued D.92-10-026, expressing continuing concern about the actual level of competition in the facilities-based portion of the cellular market, and whether we could in fact obtain the intelligence about the operation of the duopoly market on which D.90-06-025 relied. In particular, we addressed concern about potential anticompetitive cross-subsidization between wholesale and retail operations. If costs are improperly allocated between wholesale and retail operations, cross-subsidization can occur.

In D.90-06-025, we stated our intent to exert direct monitoring and control of cross-subsidization on the part of wholesale carriers. To that end, we adopted in D.92-10-026 a cost allocation methodology intended to test if cellular retail operations cover all of the costs directly associated with that business. Subsequently, in D.93-05-069 dated May 19, 1993, we modified D.92-10-026 and deferred implementation of any cost allocation modifications. We decided to reexamine our beliefs concerning the need and effectiveness of such modifications. Given the pace of technological change and anticipation of a far-reaching redefinition of the cellular market over the next few years, we expressed our intention to reexamine the questions of cross-subsidization and cost monitoring in a subsequent generic investigation. On December 21, 1993, we instituted I.93-12-007 to consider not only these questions, but comprehensive issues relating to the extent and duration of regulatory oversight required for the wireless industry.

For purposes of reviewing cellular rate adjustment applications in the intervening period prior to a final decision in the Wireless OII, we adopted interim pricing guidelines in D.93-04-058 subject to suspension or modification upon Commission action in the Wireless OII. These interim pricing guidelines were intended to give carriers that lower prices flexibility to raise rates to previous levels effective on one day's notice. For all rate increases beyond the ceiling threshold defined as carrier's then-existing rate levels, the requirements of Ordering Paragraph 9 would continue to apply.

Accordingly, since the Applicant is requesting to increase rates above its ceiling levels, it is subject to the requirements of Ordering Paragraph 9 of D.90-06-025, as prescribed by D.93-04-058 and affirmed by ALJ ruling dated October 28, 1993. Yet, the application of these guidelines in a practical sense remains problematic in the absence of a final decision in the Wireless OII. The sort of cost-of-service information sought by Ordering Paragraph 9 assumes availability of data for which measurement criteria and methodologies remain to be addressed in the Wireless OII. Moreover, we have not developed standards as to how to evaluate supporting data to conclude that a rate increase is justified and in what amount. Yet, the absence of such standards does not mean that by default we should approve rate increases. It remains the responsibility of applicant to prove that a rate increase is justified and to address the underlying difficulties in evaluating the need for rate increases. As we have stated:

> "The burden rests heavily upon a utility to prove with clear and convincing evidence that it is entitled to the requested rate relief and not upon the Commission, its staff, or any interested party to prove the contrary." (Re Southern California Edison Company [D.90-09-088] (1990) 37 CPUC2d 488, 499.)

Accordingly, we consider whether the applicant has met its burden of proof as a basis for granting the proposed increase given the current state of flux in cellular regulation. Our focus shall be on the retail increases although the issues involved relate also to wholesale increases. There are three major criteria bearing upon the reasonableness of applicant's request. These relate to (1) the alleged deficiency in earnings; (2) the relative competitiveness of its rates; and (3) the potential cross-subsidization between retail and wholesale services. On each of these major issues, we find that applicant has not justified its rate increase proposal, as discussed below.

V. Factors Bearing Upon Applicant's Rate Request

A. Deficiency of Earnings

1. Applicant's Position

The Applicant asserts that the requested rate increase is required to earn a reasonable return on its invested capital. Applicant presents 12.7% as a presumed reasonable return on investment for 1994. Since the investment represents plant and equipment, the 12.7% return is roughly analogous to the rate of return on rate base adopted for monopolistic enterprises in computing revenue requirement. In Exhibit 5, the Applicant presented data on rate of return on investment on a recorded basis for 1990-92 and projected returns for 1994, with and without the proposed rate increase.

	($000s) 1990	1991	1992	1994 Pre-Increase	Post- Increase
Net Income	$ 2,278	$ 1,442	$ 425	$ 2,509	$ 8,185
Net Investment	$31,133	$41,650	$50,820	$64,630	$ 64,630
Return	7.3%	3.5%	0.8%	3.9%	12.7%

Exhibit 5 of the application presents in more detail the income and investment data associated with these returns.

The Applicant's rates have not been increased since they were initially adopted in 1985 (D.85-05-041; D.85-07-020). Yet, the size of the Applicant's service territory has increased significantly from an initial 1,200 square miles to 12,200 square miles since 1985. The corresponding number of cell cite facilities has increased from five to 97 as of May 31, 1993. The Applicant increased its net investment in plant and facilities to accommodate this growth.

2. Discussion

The Applicant seeks to justify its requested increase on the basis of a deficiency in earnings. Presuming that a duopoly is a competitive market, applicant's first recourse to improve an earnings deficiency would seem to be by competing aggressively to increase market share relative to its duopoly competitor through lowering prices and operating more efficiently. Yet, the remedy sought in this application is to seek regulatory protection through a Commission order requiring its customers to pay higher rates. Although the applicant seeks to avail itself of the market protection akin to regulated monopolistic enterprises, it does not believe it should be held to a similar standard of scrutiny. As stated in its "Supplement to Application" dated November 19, 1993, applicant stated: "While SVLP appreciates the analysis and ruling of the Administrative Law Judge that Ordering Paragraph 9 is applicable to this cellular rate increase and is herein providing the data required... SVLP still believes that...the Commission has not and should not apply [Ordering Paragraph 9] to a cellular rate increase application and that SVLP's Application, as originally filed, was complete and adequately justified SVLP's need for this increase."

We find it logically incompatible that SVLP seeks the market protection of a regulated utility yet refuses to acknowledge its obligation to satisfy the same standard of evidence that such a regulated utility must meet as the quid pro quo for its protected franchise. The return earned by SVLP partners on invested capital is a function of billed revenues, operating expenses, depreciation, taxes, and invested capital used in serving customers. Absent a justification of these revenue and cost elements underlying applicant's claims, we have no way of testing or verifying whether or to what extent an earnings deficiency exists which would justify a rate increase.

In evaluating the validity of applicant's claims concerning deficient earnings, we must make various determinations. First, what is the appropriate methodology to measure earnings? Second, relative to what rate of return criteria should SVLP's earned return be deemed deficient? Third, assuming an appropriate target return can be determined, how much of an increase (or decrease) in the various billing factors and service levels is necessary to bring expected earnings to that level? Fourth, in a duopolistic market, what role should market competition play as an adjunct to traditional cost-plus rate relief as a tool in testing adequacy of earnings.

Under the traditional cost of service model applied to regulation of monopoly enterprises, we adopt revenue requirements designed to provide the opportunity to earn a rate of return commensurate with the risks of similar enterprises in the industry. The rate of return, expressed as a percentage applied to a rate base investment, reflects payment for the use of capital (both debt and equity) required to fund the monopoly enterprise. Even to the extent that the traditional cost-of-service ratemaking has been adapted in recent years to accommodate additional pricing flexibility in concert with the emergence of competitive markets, we have retained control over cost-of-service monitoring and established safeguards to assure captive customers interests are protected.

The traditional rate of return/cost of service model served a useful purpose in a monopolistic regulatory setting involving reasonably predictable growth keyed to test year estimates. This model, however, does not readily lend itself to the cellular industry paradigm. In D.90-06-025, we concluded that rate of return regulation as traditionally applied to monopoly enterprises would be neither efficient nor workable for cellular carriers. As we stated therein:

> "Carriers differ in their numbers of customers, precise service areas, equipment, and in numerous other characteristics that affect costs. We would be faced with setting different prices or different allowed rates of return; the former would artificially bias the market towards one carrier while the latter could be attacked on fairness grounds."

As we explained in D.90-06-025, it is economically efficient to permit an owner to keep revenues derived from the use of radio spectrum because it encourages investment and increases the supply of service to the public. Yet, we further noted that carriers should not be permitted to keep profits due solely to a failure to compete in a duopolistic market. There is an incentive to fail to compete vigorously when new entrants cannot join the market to undercut monopoly-type prices. Evidence of such failure to compete would be the pricing of cellular service high enough to discourage the full use of the system, or if carriers fail to invest in system expansion when it is economically justified. This is the very sort of wholesale pricing practice which CRA alleged in this proceeding prior to entering into the Settlement Agreement. CRA claimed that SVLP has kept wholesale prices high as a means of reducing competition from resellers. We must be careful not to approve a rate increase for SVLP if doing so would run counter to our goal of promoting vigorous price competition and full system utilization.

Since the issuance of D.90-06-025, we have had an opportunity to observe whether the duopoly structure would respond competitively by driving prices downward. As we stated last year in our Interim Opinion in I.88-11-040 (D.93-04-058):

> "The majority [of the Commission] elected to provide the industry with the opportunity to demonstrate that genuine competition existed between the duopolists. Specifically, it rejected regulation of the industry in favor of steps which would "enhance competition. The majority's expectation was that if competition were to emerge to discipline the duopolists, the evidence would be furnished by falling rates....
>
> "Three years later virtually none of the Commission's expectations have been met by industry performance."

Rather than relying on its existing prices which are below its wireline competitor to draw customers into its system and provide downward competitive pressure on prices, SVLP seeks to raise its prices up to the level approaching its competitor. This is not the payoff of competition we envisioned. We do not intend to give cursory review and approval to a request for cellular rate increases above the ceiling levels as established in D.93-04-058. Moreover, since we have yet to determine the extent to which the cellular industry is competitive, it is difficult to assess even how to measure the appropriate rate of return for evaluation of a claimed earnings deficiency, let alone grant such an increase.

SVLP has computed earnings as a return on net invested plant. In a broad sense, this measure is roughly equivalent to the return on rate base under our traditional cost of service model. In considering SVLP's claims of earnings deficiency, we shall refer to the measure of return on investment (i.e., net income divided by net depreciated plant).

While applicant seeks rate increases aimed at producing an investment return of 12.7% in 1994, no support is provided to justify why rates should be increased to yield this particular level of return. In recognition of the problems in applying cost comparisons among cellular carriers referred to earlier in D.90-06-025, we have no systematic data base of comparable returns earned within the cellular industry as a criterion for evaluating applicant's target return of 12.7%. As noted in his dissent to D.90-06-025, Commissioner Duda referenced data provided by the Commission's Advisory and Compliance Division showing earned cellular returns ranging from over 20% to over 50% (see D.93-04-058, footnote 1). Certainly, such returns do not reflect a competitive industry standard for evaluating a reasonable return funded by captive customers.

The closest we have come to approaching a rough cellular industry rate of return benchmark was in developing a break-even analysis for measuring retail cost subsidies. In D.92-10-026, we used the rate of return cap authorized in our telecommunications incentive framework proceeding for Pacific Bell Company of 14.75% as a proxy value to assess whether wholesale cellular rates are too high or if cross-subsidizations exist. Yet, the 14.75% rate does not necessarily represent a realistic investment standard for approving a cellular rate increase. Moreover, in D.93-05-069, due to impending industry changes, we expressed our hesitation at adopting any of the cost allocation methodologies which would permit such a breakeven analysis to be performed. To that extent, the question of a benchmark rate of return became moot. In short, we are left without any clear standard by which to determine what constitutes a reasonable rate of return for justifying a cellular carrier rate increase. Likewise, the application presents no evidence as to why its proposed target return of 12.7% is reasonable. Yet, the applicant asks us to grant a rate increase to permit it to earn a 12.7% return. On this basis, we find the application to be deficient in justifying its rate increase.

Even if we were to accept SVLP's claim that 12.7% is a reasonable return for 1994, the question remains as to whether granting the proposed increase in rates is necessary to achieve such a return. As a basis for its claim that the requested rate increases are necessary to yield a 12.7% return, the application presents certain assumptions about growth in both plant, expenses, and revenues. The estimates of 1994 plant growth and investment return presented in the application were given without underlying support except for brief summary statements concerning the extent of historical growth rates. Although the ALJ submitted information requests to assist in understanding the more obvious deficiencies in documentation, the resulting responses still leave questions unanswered concerning applicant's claims of expected earnings.

A significant driver of investment return appears to be the time lags between the addition of new plant and the expansion of market demand to cover fixed costs. Although the extensive growth in plant investment would seem to indicate the need for a rate increase, the corresponding growth in new customers provides at least some offset to any increased costs. Because of the rapid growth of sales and plant capacity over recent years, the applicant's return on investment has been quite volatile, as shown in Exhibit 5. This volatility caused a drop in return from 7.3% in 1990 to 0.8% in 1992. Yet, even without a rate increase, the applicant's earned return is expected to bounce back between 1992 and 1994 from 0.8% to 3.9% due to customer growth outpacing new investment. This constitutes a 387% increase in earned return between 1992 and 1994 simply due to customer growth catching up with invested capacity.

The dramatic increase in invested capital between 1990 and 1994 from $36 million to $103 million suggests that significantly untapped potential exists for improved capacity utilization and customer growth over time even without an increase in rates. Because of the dramatic increase in the applicant's projected growth over a relatively short period, its projected earnings may be sensitive to various assumptions. For example, variations in projections of retail or wholesale customer growth per unit of invested plant, average usage per customer, and increased entry of wholesalers into SVLP's service area could all affect the rate increase, if any, needed to achieve a 12.7% return.

The uncertainty over how much the return on investment would increase as a result of the proposed rate increase is apparent from a review of the complexity of rate elements which make up customers' bills. Each of the various billing elements are proposed to increase or decrease by differing percentages such that it is difficult to accurately assess how much net revenues will change in 1994 as a result. The uncertainty is not diminished by reviewing applicant's claimed gross revenue increases. For example, total average roamer revenues are expected to increase only by 45%. Yet, out-of-state roamers will face an increase in off-peak rates of 560%. For retail service, the applicant estimates it will realize only a 12.5% increase in revenues, yet it illustrates the effects of retail billing increases with an example involving an 18.1% increase.

Thus, a significant unknown in SVLP's net return assumptions concerns the balance between expansion of capacity and extent of utilization of its expanding capacity, both in terms of number of customers and usage per customer. In D.90-06-025 (36 CPUC2d at 496), we expressed concern about the potential effects of capacity underutilization on earnings. We stated that "for underutilized systems, we will expect rates to fall substantially and quickly following our grant of pricing flexibility..." We also required that duopoly carriers seeking an increase in rates "should also describe the utilization of its system relative to its current engineered capacity." Yet, SVLP has not disclosed what serving capacity will result from its huge increase in invested capacity incurred through 1994 and how this compares to its projected 1994 customer growth and billed revenues.

The uncertainty over potential growth in customer base as a result of the dramatic increase in invested capacity over such a short time period leads us to question the need for its rate increase to generate a 12.7%, assuming that return were reasonable.

Yet, another uncertainty relates to the longer term effects of the rate increase beyond 1994 because of the dynamic nature of growth within SVLP and the industry at large. The standards of earnings deficiency applied to mature monopolistic enterprises which we regulate do not necessarily apply to the duopolistic nature of the cellular industry which is still in its infancy. Even though the returns during the early 1990s have been apparently low by traditional monopoly enterprise standards, such returns have not inhibited the SVLP partners from continuing to invest huge sums in the SVLP infrastructure. To the extent such investment patterns are any indication, the potential for lucrative investor returns in future years may be significant, even without rate increases. A prudent investor would consider the discounted present value of expected future cash flows as a basis for continuing to invest capital.

In addition to the uncertainty surrounding system growth and capacity utilization over time, there is the added uncertainty concerning the nature, extent, and duration of our regulatory oversight of cellular carriers. Such questions will be addressed in the Wireless OII.

Another question relating to deficiency in earnings relates to the untapped potential of duopoly competition as a means of improving SVLP's investment return without recourse to monopoly-like cost-of-service increases. As a duopoly competitor, SVLP has the flexibility under the price guidelines established in D.93-04-058 to lower its prices as means of inducing customers of its competitor to change cellular providers. Although the short term effects of lowering prices may mean reduced revenues, the longer term effects could mean enhanced contribution to fixed costs and improved returns without the need for rate increases. This option is not available to a monopoly enterprise where it already has a captive customer base with no competitive opponent from which to expand market share.

Although we have not developed strict rate base criteria for cellular companies, the property, plant, and equipment used in SVLP's return on investment calculation generally corresponds to a rate base as discussed above. A summary of rates of return on rate base authorized most recently for a representative cross section of water, energy, and telecommunications utilities is presented as Appendix D. These returns provide a broad measure of authorized returns for regulated monopolistic firms operating in California. As shown in Appendix D, for energy utilities, we authorized 1993 returns on rate base investment consistently below 9.5%. For the large telecommunications utilities, represented by General Telephone, we adopted a rate-of-return band with a floor of 7.75% and a ceiling of 15.5% during 1993. For water utilities, we adopted returns between roughly 9.5% and 11%.

Using the returns in Appendix D as a benchmark for evaluating SVLP's target return on investment for ratemaking purposes is reasonable given the uncertainties over valuation of cellular investments as discussed above. On this basis, a return on investment in the range of 9.5% - 10% is more reasonable for purposes of determining a 1994 earnings deficiency to be funded